

service Order Instituting Rulemaking (OIR)/OII.<sup>43</sup> DRA maintains that it is inappropriate to eliminate the formula until the Commission has found that effective local competition exists. Mr. Mirza remarks that competition in local exchange markets will not evolve immediately, but over time. He argues that to presently eliminate the formula would leave most local exchange ratepayers, specifically residential and small business customers, in the worst of both worlds. There would be no effective competitive alternatives and no ability to benefit from the further productivity improvements likely to occur due to continuing technological advancements and the effects of developing local competition.<sup>44</sup>

With respect to the impact of the productivity factor on Pacific's and GTEC's overall financial health, DRA stresses that the Commission set floors and ceilings on earnings as part of the price cap mechanism to protect shareholders and ratepayers from the risk that the formula as driven by X would sometimes under-or overestimate the earnings. Mr. Mirza notes that the Commission recognized that TFP studies and the adopted value of X (including the stretch factor) could not perfectly predict actual productivity.

DRA reports that Pacific's 1st and 2nd quarter 1995 financial results indicate that earnings per share are down from the same quarters in 1994.<sup>45</sup> DRA contends that while erosion in toll earnings has contributed to the downturn, several influences need to be analyzed. From January 1, 1995 through June 30, 1995 Pacific's 10Q filing with the SEC states that Pacific lost about 6% of the toll market it had as of January 1, 1995. Pacific

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<sup>43</sup> Exhibit 58 at 2-2.

<sup>44</sup> Id. at 2-3.

<sup>45</sup> Id. at 2-5.

indicates that its market share of the "business" toll market was down 25% at this point. Later, citing updated total intraLATA toll market studies, Pacific states its overall "business" market share is about 60%. DRA cautions that this claim, based on unpublished market studies, is unverified.<sup>46</sup>

DRA witness Mirza asserts that 6 months of data may well be inadequate for the full elasticity effects (full stimulation) to be realized, and reliable conclusions to be drawn. He maintains that it is not clear at this juncture that Pacific's earnings will continue to erode because of toll competition. He points to the California economy and Pacific's actual productivity performance as contributing factors to the company's earnings showing.<sup>47</sup> Mr. Mirza declares that Pacific Telesis' rate of return on equity for the 6 months ending June 30, 1995 was about 20%, commensurate with many other telecommunications companies. For the 12-month period ending June 30, 1995 Pacific Telesis Group reported a 20.9 percent rate of return on equity, Ameritech reported 27.2 percent, and Bellsouth reported 17.9 percent. The group composite for 11 telephone companies including Pacific Telesis was 21.0 percent.<sup>48</sup>

Dr. Thomas M. Renaghan testified that while the Commission rejected "the notion of making an explicit recognition of an LEC input price differential" in D.94-06-011, the FCC has

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<sup>46</sup> Id. at 2-5.

<sup>47</sup> Citing Pacific's August 15, 1995 Intrastate Earnings Monitoring Report, DRA states the company's intrastate rate of return was about 9.4% for the 5 month period ending May 1995, 0.6% below the market rate of return of 10% adopted in D.94-06-011. DRA witness Mirza states that the still recovering California economy may best explain such a slight movement below the Commission-set market rate. Id. at 2-7.

<sup>48</sup> Id. at 2-6, footnote 16.

recently taken a "more sympathetic view." Citing a FCC staff study<sup>49</sup>, Dr. Renaghan states that estimates of the LEC input price differential before the FCC were based upon a comparison of telecommunications industry versus nationwide input price changes, rather than the company-specific data analyzed in D.94-06-011. He reports that the FCC's economists concluded that the inclusion of an input price differential in LEC price caps has a strong conceptual and empirical foundation.<sup>50</sup> Dr. Renaghan declares that on the basis of relative input shares, there is both a conceptual as well as empirical basis from which to conclude that aggregate LEC input price growth differs from economy-wide input price growth as long as prices of capital and labor services grow at different rates.<sup>51</sup>

#### CCLTC

CCLTC asserts through the testimony of Dr. Lee L. Selwyn<sup>52</sup> that there is no need for any fundamental change in NRF's structure at this time; however, certain "mid-course corrections" should be studied. CCLTC submits that the onset of local competition comes as no surprise to the LECs, and is unlikely to engender significant or immediate operational changes for them upon its inception early next year. CCLTC puts at issue Pacific's and Dr. Christensen's inability to provide certain information and data underlying Christensen's productivity study, as well as the failure of the study to take into account the input price growth differential.

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<sup>49</sup> C. Anthony Bush and Mark Uretsky, Input Prices and Total Factor Productivity, Appendix F, FCC Docket, CC 94-1.

<sup>50</sup> Exhibit 58 at 5-5.

<sup>51</sup> Id. at 5-7.

<sup>52</sup> Exhibits 62 and 63.

Dr. Selwyn testified that the X factor formula should include the post-divestiture LEC productivity growth plus a LEC input price differential plus an appropriate stretch factor, in order to reflect the efficiency incentives found in competitive markets and to ensure ratepayer protections. Dr. Selwyn declares that the X factor should be based properly upon "forward-looking" price and productivity trends, not long-term historical conditions.

He recommends that to the extent that forward-looking price and productivity forecasts may be difficult to obtain, only the post-divestiture time frame (1984-forward) -- the most recent period -- should be used in estimating productivity growth rates and input price differentials. Dr. Selwyn insists that use of the longer-term input price relationships advocated by Pacific, GTEC, and other LECs, puts forth a misleading indication of current conditions in the input factor markets and is fundamentally inconsistent with recent productivity studies commissioned by the LECs in connection with FCC and state price cap proceedings.

Dr. Selwyn urges the adoption of a post-divestiture informed input price differential in setting the productivity factor, as the FCC did in its 1994 price cap review. He presents a productivity factor, utilizing his formula, of 5.7%.

#### AT&T

AT&T urges the Commission to retain the current price cap formula for services in Categories I and II. AT&T maintains that, by design, the price cap formula is to apply to a service until the service faces effective competition. The evolution of telecommunications markets and the possibility that LECs' services would evolve from monopoly to effectively competitive was anticipated and built into the NRF. Through the testimony of Dr. John W. Mayo, AT&T asserts that certain steps should be taken to inform the Commission determination of when regulation should

be replaced by market forces as the primary vehicle for allocating a firm's resources.

Dr. Mayo states that in order for a service to be found to be effectively competitive, or moved to Category III, the LEC should initially define the relevant market(s) within which the service is sold. Next, Dr. Mayo submits, the LEC should present evidence regarding its share of the market in which the service is sold; the height of barriers to entry and expansion, if any exist; and the nature of overall demand conditions in that market.<sup>53</sup> Dr. Mayo insists that for those services that are effectively competitive, the LECs should enjoy essentially complete pricing flexibility. However, he admonishes, for those services that remain subject to significant monopoly power, the market cannot be relied upon to generate efficient prices.<sup>54</sup> He advises the Commission to maintain controls on those services' prices.

AT&T asks the Commission to look closely at whether or not the LECs have attempted to alleviate any of the pressures they have identified through reclassification under the framework and, if not, why not? AT&T declares that the fact that regulatory and marketplace changes are now occurring, should not change the fundamental soundness of an approach that links the overall degree of regulatory flexibility to the degree to which the incumbent LECs face competition. Citing CCLTC witness Dr. Selwyn's testimony on the "appropriate" productivity factor, AT&T maintains that the productivity factor should be retained at levels no lower than 5%.

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<sup>53</sup> Exhibit 67 at 7; AT&T Brief at 16-17.

<sup>54</sup> Exhibit 67 at 11.

**MCI**

MCI states that the Commission should not eliminate the current inflation minus productivity factor, nor should it modify the formula to reduce the productivity factor unless it adopts a "True Price Caps" (TPC) regulatory regime for Pacific and GTEC. MCI witness Dr. Nina W. Cornell describes TPC as the only price cap format that "would be fully consistent with the move to open local exchange markets to entry and that would ensure that consumers get the maximum possible benefits from the changes that are occurring in telecommunications markets in California."<sup>55</sup>

Dr. Cornell testified that the current framework, "a hybrid of rate of return regulation and price cap regulation," does not provide the best transition from monopoly to competitive telecommunications markets. She submits that the first part of the hybrid, in which the incumbent continues to be allowed to set and reset rates to attempt to recover a revenue requirement thwarts lower prices. Further, Dr. Cornell maintains that the existing framework incorporates excess costs into the prices dependent competitors pay for monopoly input functions, possibly creating anticompetitive pricing opportunities for the LECs and artificially high pricing floors.

Dr. Cornell recommends the adoption of the following five features of TPC at the same time or before the Commission eliminates the GDPPI minus X:

- Setting the rates for all Pacific/GTEC monopoly input functions needed to provide retail services at their direct economic costs.
- Capping the rates for Pacific/GTEC's retail services that are not competitive at existing rates.

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<sup>55</sup> Exhibit 24 at 3.

- Eliminating all earnings reviews and sharing requirements for Pacific/GTEC.
- Eliminating all price regulation of Pacific/GTEC's competitive functions and services.
- Eliminating periodic cost studies of existing Pacific/GTEC telecommunications functions and services after completion of Open Network Architecture Proceeding (OANAD or Rulemaking (R.) 93-04-003/I.93-04-002).<sup>36</sup>

MCI declares that its proposal is consistent with ongoing Commission efforts to remove competitive entry barriers, provides an efficient and pro-competitive approach to staged elimination of earnings regulation for the LECs and allows for significantly increased LEC regulatory flexibility.

#### CCTA

CCTA submits that the existing framework should not be changed as a general matter because it already anticipates the advent of competition, as well as prompting its own demise through the reclassification of services. CCTA argues that conceivably all LEC services could become fully competitive someday. Moreover, under the current NRF, services could be moved from Categories I and II to Category III, and would be removed from those classifications' pricing restrictions. CCTA contends that, consequently, application of the price cap mechanism would cease in its entirety.

The association declares that the existing framework has not diminished the financial health of Pacific or GTEC. CCTA maintains that "but for the advent of competition and the scheduled triennial review of the NRF, Pacific would have no

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<sup>36</sup> Id. at 5-6 and MCI Brief at 4.

grounds in light of its earnings upon which to petition the commission for review or revision of the NRF framework."

(CCTA Brief at 4-5.) It characterizes the present productivity factor as reasonably set to provide Pacific and GTEC a fair opportunity to earn a return on their investment. CCTA asserts that Pacific's spinoff of its cellular telephone operations has had a greater negative impact on the LEC's earnings than the NRF has.

CCTA addresses the questions of how and when the price cap mechanism should be modified through the testimonies of Dr. Francis Collins and Dr. Frank Wolak.<sup>57</sup> Dr. Collins contends that the transition from full regulatory supervision to decreased oversight in a competitive marketplace must address the definition, application, monitoring and enforcement of service quality standards.<sup>58</sup> Dr. Wolak recommends a set of targets for reducing the barriers to new entrants participating in local exchange markets and urges the Commission to attach to these targets any regulatory relief it might determine to give the LECs.<sup>59</sup>

#### TURN

TURN contends that GDPPI minus X in the price cap formula should not be eliminated. The inflation minus productivity factor should be modified only to the extent of ensuring the ratepayer protection of having the X factor include the effects of competitive market efficiencies. TURN declares that the spinoff of Telesis' Pactel and wireless subsidiaries has adversely affected Pacific. It argues that the Telesis spinoff decision bars the company from seeking changes to the

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<sup>57</sup> Exhibits 54 and 55-56, respectively.

<sup>58</sup> Exhibit 54 at 6.

<sup>59</sup> Exhibit 56 at 31-36.



productivity factor as a means of addressing any perceived financial stresses. TURN maintains that Pacific paints a "distortedly favorable pre-NRF financial condition; and a distortedly unfavorable post-NRF financial condition" and "inappropriately links financial impacts to NRF that were unrelated to NRF." (TURN Brief at 3.)

TURN states that until ratepayers can enjoy the benefits of effective competition in all local markets and for all services, they should receive, as intended by the price cap formula, the efficiencies of marketplace competition. TURN notes that significant competition has not yet developed and will occur only slowly for residential ratepayers.

CTC-California<sup>60</sup>

CTC-California supports Pacific's and GTEC's position that the Commission should adjust LECs' price cap formula to account for the introduction of full competition in the local exchange market. CTC-California maintains that the price cap formula was intended to be "a regulatory surrogate for competition and to provide an incentive for NRF LECs to operate efficiently, as if they were operating in a competitive marketplace." (CTC-California Brief at 3.) It argues that the rationale for the price cap formula disappears once competitors are allowed to enter the market and compete with LECs. CTC-California insists that while competition may not come immediately to all customers in all markets, LECs should not be required to show that they have lost some percentage of their

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<sup>60</sup> Citizens Telecommunications Company of California Inc.. D.95-03-017, as modified by D.95-04-034 and D.95-08-001, authorized Citizens Utilities Company of California (CUCC) to separate its telephone and water properties. Under the new structure, the telephone properties operate as CTC-California, a new separate corporate entity. The water properties continue to operate as CUCC.

customers before obtaining relief from regulation intended for a monopoly environment. (Id. at 4.)

DOD/FEA<sup>61</sup>

DOD/FEA declares that the inflation minus productivity portion of the price cap formula should not be eliminated as long as the LECs retain significant market power.<sup>62</sup> DOD/FEA urges the adoption of a X factor which is based on the most recent study of nationwide telecommunications TFP growth, adjusted by an input price proxy which more accurately reflects telecommunications input prices and a 50 point stretch factor, as in the first triennial review decision.

DOD/FEA sympathizes with the LECs' assertion that a "double hit" or "double counting" results from the carriers having to reduce prices for competitive services in the face of growing competition, and then also having to reduce overall prices in response to the price cap mechanism. The agencies submit that there is merit to the LECs' argument given that their present rate structures are not cost based, but the solution proposed is inappropriate. They encourage a revision of the procedures for distributing rate increases and decreases that result from the NRF mechanism. DOD/FEA proposes that surcharges be added to the prices of services which are underpriced and surcredits be subtracted from the prices of services which are overpriced. The agencies also recommend credits for competition driven rate decreases that the LECs file between NRF adjustments.<sup>63</sup>

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<sup>61</sup> U.S. Department of Defense and All Other Federal Executive Agencies.

<sup>62</sup> DOD/FEA Brief at 5.

<sup>63</sup> Id.

**CWA**

CWA urges the elimination of the productivity factor, commenting that the "mere presence of competitors sparks an incentive for productivity improvements" among the LEC employees since "the efficient competitor will just as directly threaten the security of our jobs as does the productivity factor."

(CWA Comments at 3.) CWA contends that the productivity factor is fundamentally unfair to the LEC workers, and unnecessarily threatens their jobs. CWA further states that maintenance of the productivity factor impacts both quality of service and LEC ability to invest in infrastructure. Should the Commission decline to eliminate the X factor at this time, CWA asks the Commission to reduce it significantly and "set a date for the factor to implode on its own once local competition is in full swing." (Id. at 5.)

**Discussion**

In designing the NRF, the Commission joined LEC regulatory flexibility for any particular service to the level of competition faced by that service.<sup>64</sup> We crafted three categories to track the progress of a service from full monopoly (Category I), to the emergence of incipient competition (Category II)<sup>65</sup> and finally, to the establishment of effective competition for the service (Category III). Each category grants different levels of pricing freedom. Specifically, services in Categories I and II are subject to "price caps" that limit their upper bounds to levels established at the outset of the framework. These bounds are subject to annual adjustment according to the price cap formula which permits rates to rise by the level of

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<sup>64</sup> See, 33 CPUC 2d 125 (1989).

<sup>65</sup> "Category II will include discretionary or partially competitive services for which the local exchange carrier retains significant (though perhaps declining) market power." Id.

inflation, minus an offset to reflect the LECs' increase in productivity during the preceding year."

As a significant aspect of the NRF, the Commission granted LECs the authority to seek the transfer of a service from a more restrictive to a less restrictive Category, upon a showing that competition for that service has developed to the point where it meets the criteria for inclusion in the less restrictive category. We stated:

"As the intraLATA market becomes increasingly competitive, we also expect to see eventual migration of services from Category I or II to Category II or III. ... Since we would want to review and evaluate market conditions to ensure that customers and/or the competitive market are not harmed by classification changes, Pacific or GTEC must make any such request through the application process...."<sup>67</sup>

In this phase of the proceeding, Pacific and GTEC have chosen to broadly address the strength of competition across markets rather than discuss the specific effects of the current state of competition upon Category I or II services. The LECs contend that the Commission should change the operation of the formula concurrent with the opening of the local exchange market to competition.<sup>68</sup> However, they have provided the Commission with very little that can be considered solid evidence of the deleterious impact upon the LECs of the "rapidly accelerating" competition that they perceive in California.

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<sup>66</sup> The formula allows exogenous or "Z" factor increases or decreases to account for costs caused by elements outside the LECs' or the Commission's control.

<sup>67</sup> Id. at 127.

<sup>68</sup> Exhibit 29 at 1, 16 and Exhibit 35 at 2.

While Dr. Harris' report is a fascinating treatise on the potentially vast array of competitors that will or may face Pacific (and GTEC) in the near or distant future, we must agree with AT&T, CCLTC and DRA that the presentation was general, speculative and a miscellany of diverse statistics, "anecdotes, press releases, [and] newspaper reports."<sup>69</sup> Dr. Harris' testimony provides the promise of the future of telecommunications in California's local exchange market and beyond, but this indeterminate prospect responds to few of our concerns about the transition from significant to declining market power.

Looking initially at the evidence that the LECs submitted on the pace and power of competition on Category II services, the bulk of it concerns toll services (i.e. 800 and MTS). Citing a Quality Strategies, Usage Track Report commissioned by Pacific during the second quarter of 1995, Dr. Harris testified that Pacific currently carries only 56% of the California intraLATA business toll traffic<sup>70</sup> and "a tiny 6% share" of the California market for 800 services<sup>71</sup>. However, the significance of the intraLATA business toll traffic figure is difficult to analyze, and the 800 services' market share number raises troubling questions.

In the IRD proceeding, the LECs stated that they had already experienced significant competitive toll losses. Here, neither Harris nor Pacific offered data regarding the company's intraLATA business toll market share prior to the Commission's authorization of intraLATA toll competition. As DRA aptly notes, without this vital basis of comparison, the reported Quality

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<sup>69</sup> AT&T Brief at 6.

<sup>70</sup> Exhibit 14 at 21.

<sup>71</sup> Id. at 22.

Strategies study results convey nothing of the alleged effects of the post-IRD toll competition on the LECs. The study, instead, appears as "a snapshot of business intraLATA toll market share for a 30-day period in the second quarter of 1995."<sup>72</sup>

DRA points out that, as it would have anticipated, the Quality Strategies study further reveals that Pacific retains a higher percentage of the minutes of use of small business customers than medium or large business customers, 81%, 60%, and 46%, respectively, for intraLATA toll. DRA calculates that business minutes of use comprise only one third of all of Pacific's minutes of use; thus, the study does not illustrate the company's total intraLATA toll market. (DRA Brief at 12.) Accordingly, while the Pacific stated figure might be of consequence, its significance is not clear from this record.

Pacific reports that competition from interexchange carriers (IXCs) has had "a dramatic impact on Pacific Bell's share of 800 services."<sup>73</sup> Pacific calculates that 800 services in California represent almost 9 billion minutes of use, and the company's share is 6%. AT&T submits that Pacific's provision of this figure is not relevant to determining the vigor of competition in markets in which the company may compete because the data from which it arises is a compilation of intraLATA, interLATA, and even interstate, 800 traffic. (AT&T Brief at 29.) Moreover, it is not apparent why Pacific, given its share of the market<sup>74</sup>, has not sought Category III treatment of those

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<sup>72</sup> DRA Brief at 12. It appears that there has been no verification of the accuracy of the study. DRA advises that time constraints prevented it from fully analyzing the necessary data. Dr. Harris testified that he did not verify the study's accuracy. 2 Reporter's Transcript (RT) 300-302.

<sup>73</sup> Exhibit 14 at 22.

<sup>74</sup> 2 RT 363, line 8.

services. We concur with AT&T that, in the proper context, the significance of Pacific's showing regarding its share of the California 800 services market becomes hazy.

Indefinite conclusions can also be drawn from the LECs' evidence submitted on two other Category II services: high-capacity private line service (HiCap) and intraLATA toll service. In support of the contention that "Competition in access services is vigorous and growing rapidly,"<sup>75</sup> Dr. Harris presented a comparison of market share statistics regarding HiCap services developed by Quality Strategies for the second quarter of 1993 and the third quarter of 1995.<sup>76</sup> Pacific and GTEC submitted evidence on the intraLATA toll market share since January 1, 1995.

The Commission has allowed competition for HiCap services for more than 6 years.<sup>77</sup> These services are purchased almost exclusively by large business users who are generally the most sophisticated consumers and most aware of the available competitive alternatives. Therefore, one could look to the level of competitive penetration in the HiCap market as a gauge on the level of entry that one might expect in a newly-opened market over a medium range of time. In its presentation, Pacific focused on the current market share in the San Francisco area and Los Angeles. Upon initial examination, the statistics cited appear to indicate vigorous competitive activity in the California HiCap market. Significant to the interpretation of the results, however, Dr. Harris' report does not state that the survey from which the data was drawn made no distinction between

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<sup>75</sup> Exhibit 14 at 14-15.

<sup>76</sup> The third quarter 1995 study was designated as proprietary, and received into evidence under seal as Exhibit 23.

<sup>77</sup> See, D.88-09-059.

HiCaps used for intraLATA service and those used for interLATA service.<sup>78</sup> Moreover, absent from the report were the comprehensive results of the study which appear to indicate that while Pacific may be losing share in its largest markets, it continues to wield significant market power in the other areas that it studied in the state. Examining Pacific's data on HiCap services certainly reveals no clear-cut evidence on the vigor of competition in the relevant market.

Pacific and GTEC emphatically cite their declining market shares in intraLATA toll after the January 1 implementation of competition. However, CCLTC, DRA, TURN and AT&T specifically assert that the LECs' loss of market share is not significant. Pacific reports a loss of approximately 6 percent as a result of 10XXX switched toll bypass.<sup>79</sup> GTEC indicates a loss of 7.5 percent for the first six months of 1995.<sup>80</sup> DRA points to the inconvenience of dialing 10XXX as a further inhibitor of declining toll market share.<sup>81</sup> Pacific's witness claimed that such was an inconsequential barrier to entry. In fact, based on studies he performed in Illinois and Wisconsin, Dr. Harris referred to the "relative ease" of 10XXX dialing.<sup>82</sup> However, under cross-examination, Dr. Harris stated that: 1) he had not performed a study in California on 10XXX

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<sup>78</sup> 3 RT 410, lines 6-7; Exhibit 23 at 40-58.

<sup>79</sup> Exhibit 14 at 21, 2 RT 300, lines 2-13.

<sup>80</sup> Exhibit 28 at 3; 3 RT 493, lines 14-24. DRA notes that GTEC's calculation does not account for misdialed local calls, and comments that given Pacific's level of misdialed calls that GTEC's loss is probably comparable to Pacific's. (DRA Brief at 11.)

<sup>81</sup> Exhibit 59 at 2-3; DRA Brief at 11.

<sup>82</sup> Exhibit 15 at 8; 2 RT 311, lines 12-20.



usage; 2) he had found that customers prefer to dial fewer digits; and 3) lower volume callers do not dial 10XXX.<sup>83</sup>

We have little way of knowing, based on the record before us, what the declining intraLATA toll market share numbers indicate about the pace of competition in the market and the projected damage that the LECs might sustain. These numbers are the product of approximately 5 months of data.<sup>84</sup> If the intraLATA toll market is comparable to the interLATA market, market share loss could slow after the first two years of competition. Referring to the Commission's Advisory and Compliance Division's (CACD) February 1995 Report on 1992 Interexchange Market, DRA advises that while AT&T lost considerable market share in the first two years of competition, market share loss then slowed. From 1984 to 1992, AT&T's intrastate market share fell from 100 percent to 88, 80, 77, 75, 70, 67, 65 and 62 percent.<sup>85</sup> CCLTC remarks that Pacific describes 6% market share as "tiny" when characterizing the company's part of the 800 services market.<sup>86</sup> We note that it is to be expected that when competition is introduced into a market served by a monopoly provider there will be a loss of market share by that provider. What this evidentiary record does not tell us is that the LECs' intraLATA toll market share loss is extraordinary and unprecedented.

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<sup>83</sup> 2 RT 313 and 337.

<sup>84</sup> GTEC estimates that the ongoing level of revenue loss averages \$3.5 million per month from March through June or \$42 million on an annualized basis. GTEC Brief at 6; Exhibit 51.

<sup>85</sup> DRA Brief at 11, note 27.

<sup>86</sup> CCLTC Brief at 5, footnote 1.

The LECs envision fierce competition in the local exchange market in the immediate future.<sup>87</sup> They list the vast resources of AT&T, MCI, Sprint, TeleCommunications Group, Metropolitan Fiber Systems, Century Telecommunications and Continental Cablevision: the "large, well-funded and sophisticated competitors" on the horizon.<sup>88</sup> The companies highlight the threat posed by the IXCs, the competitive access providers (CAPs), personal communication services (PCS), cable companies, and wireless providers. GTEC observes that more than 60 firms filed applications on September 1, 1995 for authority to provide local service throughout its present service areas.<sup>89</sup> However, most of the other parties dispute the immediacy of the rapid pace that Pacific and GTEC foresee. With the exception of CTC-California, CWA and the LECs, the other parties assert that competition in local exchange will develop over time.

While the potential posed by the abundance of technology is broad, closer analysis reveals a less expansive view of the near future. The LECs cite the total company revenue of several of their potential competitors; yet, Dr. Harris stated that the combined plant capacity of all of Pacific's potential competitors is not sufficient to displace Pacific.<sup>90</sup> Pacific and GTEC stress that falling cellular rates will increase the competitive advantage of wireless communication. However, as DRA indicates, we have found that: 1) cellular rates for basic plans have remained inert or declined slowly; 2) discount plans have only offered moderate rate relief to customers; 3) and discount

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<sup>87</sup> Pacific Brief at 12; GTEC Brief at 8.

<sup>88</sup> GTEC Brief at 9; Exhibit 27 at 14-15; Pacific Brief at 12-15.

<sup>89</sup> GTEC Brief at 9.

<sup>90</sup> 2 RT 363, lines 14-25.

plans have offered no rate relief to low use customers in Los Angeles, the largest cellular market.<sup>91</sup> Moreover, Dr. Harris concedes, when comparing cellular's current monthly rate of between \$35 and \$40 to Pacific's \$14.75 rate for exchange service, that on a "line-by-line basis" the two services are not price competitive.<sup>92</sup>

The testimony regarding anticipated competition from cable companies reveals that the peril that they pose is not imminent. Under cross-examination, Dr. Harris discussed the pending cable-to-telephony technology controversy: "Yes, I would say that there's uncertainty about which particular technological route is the best one to follow, and among industry participants there's disagreement over which of those is the best, yes."<sup>93</sup> It appears that upgrading existing cable facilities to provide telephony may take time and significant expense, and it is unclear whether or not cable will be able to compete with the LECs in either price or quality. Additionally, Dr. Harris' assertion that cable companies will offer local exchange service "as soon as federal and state regulations permit,"<sup>94</sup> may not be as easy as it sounds in terms of federal permission.

Several parties characterize PCS as a potential competitor in the local exchange market of the distant future. PCS has not yet been commercially deployed anywhere in the United States. Although licenses have been awarded, like cellular systems, PCS may have to rely on wireline systems to complete almost all of its calls. AT&T and DRA comment that since Pacific holds PCS licenses for San Francisco and Los Angeles, some of the

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<sup>91</sup> DRA Brief at 10.

<sup>92</sup> 2 RT 365, lines 22-28.

<sup>93</sup> 2 RT 319, lines 7-10

<sup>94</sup> Exhibit 14 at 29.

eventual competition from PCS will be intra-firm rather than from exterior rivals."<sup>55</sup>

The record in this phase documents a level of competition in the California telecommunications arena that is neither as rapid and crushing as the most optimistic assessment, nor as static and remote as the most pessimistic appraisal. Viewed in the most favorable light, the LECs' showing indicates that several, but not all Category II services face increasing competition. With respect to Category I services, the evidence reflects that the actual course of development for local exchange competition is too speculative to serve as a basis for regulatory rules premised on the presence of effective competition for local exchange services. The overall testimony does not support the finding that all LEC Category I and II services currently should be treated as if they face effective competition. Accordingly, we hold that Pacific and GTEC should not be exempted from the price cap formula for all Category I and II services at this time.

Pacific's witness Evans testified as to the damaging effect of the price cap formula upon the finances of the company."<sup>56</sup> In contrast, during the initial review of NRF, Mr. Evans stated that:

"Pacific's operating results over the review period, though constrained, remained within a reasonable range, neither exceeding the ROR cap nor falling below the ROR floor. Although Pacific did not achieve the sharable earnings level, its results reflect the balance and stability sought in NRF. This balance and stability was achieved despite a severe and lingering recession,

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<sup>55</sup> AT&T Brief at 31-32; DRA Brief at 10.

<sup>56</sup> Exhibit 29 at 1, 6 and 16.

substantial revenue reductions over the review period, and accelerated revenue losses as competition intensified in all of Pacific's markets. Pacific believes that NRF has worked well in promoting the Commission's goal of Financial and Rate Stability."<sup>97</sup>

DRA, AT&T, CCTA and TURN emphatically contest the LECs' claims of deteriorating financial performance as exaggerated and not primarily the result of the price cap mechanism.

Reviewing Pacific's and GTEC's NRF monitoring reports, DRA notes that when compared with total company operating revenues for January to June 1994, Pacific's January to June 1995 total company operating revenues have only declined slightly, by approximately 2.3 percent. Moreover, Pacific's total company operating revenues for July 1995 are nearly equal to its total company operating revenues for July 1994. Similarly, it appears that GTEC's total company operating revenues for January to June 1995 have only decreased approximately 5% from their level for January to June 1994. For GTEC, June 1995 total company operating revenues actually exceeded June 1994 total company operating revenues."<sup>98</sup>

Generally, Pacific's and GTEC's intrastate rates of return have met or exceeded the market-based rate of return.

Actual Intrastate Rate of Return (in percents) +

<u>Year</u>	<u>P*B ROR</u>	<u>GTEC ROR</u>	<u>Adopted Market ROR</u>
1990	12.39	13.41	11.50
1991	11.31	14.09	11.50
1992	12.03	14.20	11.50

<sup>97</sup> A.92-05-004 et al.: Exhibit 41 at 6.

<sup>98</sup> PD-01-014 and GD-04-00, respectively. Monthly operating revenues for Pacific for January 1994 through July 1995 and for GTEC for January 1994 through June 1995. DRA Brief at 14.

1993	9.51	13.28	11.50
1994	11.17	12.33	10.00

Source: Exhibit 60

GTEC exceeded the market-based rate of return for every year between 1990 and 1993. Had GTEC not entered into a settlement agreement, the company would have exceeded the return that would have been considered for it in 1994. Pacific's intrastate rate of return was close to or exceeded the market-based rate of return for every year from 1990 through 1994 with the exception of 1993, when it had a \$1.567 billion accounting adjustment to establish a restructuring reserve for the costs associated with force adjustment programs. Notwithstanding, the following shows the most recent Commission data on monthly RORs for 1995:"

<u>Month</u>	<u>P*B ROR</u>	<u>GTEC ROR</u>
Jan	11.45	7.875
Feb	8.89	11.080
Mar	6.24	9.963
Apr	8.99	8.050
May	11.27	3.008
Jun	6.59	7.329
Jul		14.053
<u>Aug</u>		<u>7.466</u>
Y-T-D	8.92	8.602

Sources: P.O. 01-27; G.O. 04-00

How much of Pacific's financial situation is attributable to the implementation of NRF? The evidentiary record does not support the view that all or even a majority of the decline in the company's revenues is the result of NRF. The S.G. Warburg Research Statistical Summary<sup>100</sup> tabulated Pacific's

<sup>99</sup> The adopted ROR for 1995 is 10.00.

<sup>100</sup> Exhibit 41 at 20.

revenues from 1984 through 1994. Pacific witness Evans presented a list of revenues from 1984 through 1989.<sup>101</sup> Both exhibits show revenues declining from 1986-1987, from 1988-1989, from 1989-1990 and from 1990-1991. The only post-NRF year in which revenues declined was the first year of the operation of NRF. Actually, Pacific's revenues started to flatten in 1989, before NRF went into effect.<sup>102</sup> Exhibit 16, measuring the total return indices, price change plus reinvested dividends for the RBOCs, indicates that since 1984, Pacific, as the subsidiary of Pacific Telesis Group, has placed in the middle of the RBOCs/Regional Holding Companies (RHC) in stock performance. Pacific's return on equity for the 12-month period ending June 30, 1995 was commensurate with other RBOCs.<sup>103</sup> Moreover, according to Exhibit 65<sup>104</sup>, a May 1995 Salomon Brothers report, Pacific Telesis' dividend yield is 8.1%, the highest<sup>105</sup> of the RBOCs. The report views Pacific's payout as too high and not sustainable.<sup>106</sup>

Pacific maintains that the Telesis wireless spinoff is irrelevant to this proceeding. However, as TURN suggests, a careful examination of the Pacific Exhibit 29<sup>107</sup> comparison of CAGRs of the LEC and six RBOCs between 1984-1994 and Exhibit 42

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<sup>101</sup> Exhibit 45, Bates Stamp 000664.

<sup>102</sup> DRA Brief at 15.

<sup>103</sup> Exhibit 58 at 2-6.

<sup>104</sup> *Regional Bell Operating Companies (RBOCs) -- Creeping Competition in Local Service Implies Shrinking Margins and Market Share for RBOCs* at 3.

<sup>105</sup> Second highest is NYNEX at 5.7%.

<sup>106</sup> Confusingly, the Salomon report often interchanges its discussion of RBOCs and RHCs.

<sup>107</sup> Exhibit 29 at 11: Table 2-"Telephone Company Revenue \$M".

challenge the company's assertion. Pacific reports its revenue growth under incentive regulation as 0.53% CAGR, the "lowest among the seven RBOCs." (Exhibit 29 at 11.) Recalculating the CAGR to include the revenue that would have been realized by Telesis absent the spinoff, for 1984-1994 the CAGR would have been 1.57% or almost triple the growth rate that occurred in light of the spinoff.<sup>108</sup> While time constraints prevented us from more fully exploring this issue on the record, we find less than persuasive Pacific's contention that the 1994 spinoff of PacTel and its wireless subsidiaries has had no effect on the LEC's financial picture.

While we fully appreciate the cumulative effect of the price cap formula upon the LECs, it is clear that the state's economy has also had a definite impact on revenues. Nevertheless, forecasts predict that California can expect to outperform the nation in the next few years.<sup>109</sup> Testimony indicates that Pacific will continue to realize efficiency gains.<sup>110</sup> Overall, we conclude that Pacific's declining revenues are the result of numerous factors, rather than solely or predominantly the effects of NRF.

In the last review, we undertook what appears to be the perennially controversial examination and determination of the appropriate productivity factor. D.94-06-011 reaffirms our Phase II resolution "to look to a target which is a differential productivity adjustment supported by information outside the utility's control with a 'stretch' added."<sup>111</sup> Although the prospect of the BLS's long-promised index continues to hold some

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<sup>108</sup> TURN Brief at 3-4.

<sup>109</sup> Exhibit 58 at 2-6.

<sup>110</sup> Exhibit 29 at 9; 4 RT 613, line 17 to 614, line 5.

<sup>111</sup> D.94-06-011, mimeo at 37.



fascination for the Commission, national fiscal reality indicates that we must look elsewhere for one or several studies "that capture the essential parameters of the methodology that we have held to be reasonable."<sup>112</sup> Pacific presented Dr. Christensen's direct testimony (Exhibit 6) ostensibly in satisfaction of our request.

Among other determinants, the compressed schedule of this phase of the proceeding helped to undermine the value of Dr. Christensen's study to us. The Commission would have greatly preferred the study either to have been sponsored jointly or to have been equally accessible for validation by all parties. Instead, the Christensen study appears before us as a Pacific or LEC study.

Based on the results of his study, Dr. Christensen recommends a productivity or X factor of 2.1%. As Pacific emphasizes, Dr. Christensen's short-term study results are consistent with the long-term telephone industry TFP differential<sup>113</sup>. The results are also consistent with GTEC's Phase II "long run productivity proposal" which we rejected. In D.89-10-031, we stated that we were not convinced that sole reliance on "historical productivity data" would be appropriate. We still are not convinced. Exhibit 43 indicates that had the Commission adopted an initial productivity factor of 2%, Pacific would have earned returns over the benchmark NRF level from 1990 through 1995.

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<sup>112</sup> Id.

<sup>113</sup> Pacific Brief at 31.